9.02 Sale & Pledging of Receivables

On occasion, a client will want to generate cash from a receivable without waiting until it is collected from the customer. There are **four basic techniques** available:

- **Pledging** – The client borrows the necessary cash, and "pledges" (offers) the receivable to the lender as collateral to secure the loan. When this occurs it must be *adequately disclosed* in a footnote in the financial statements (F/S).
- **Assigning** – The client borrows the necessary cash, and agrees to use the proceeds from the receivable to repay the lender. Sometimes, the customer is notified to make payment directly to the lender instead of the client.
- **Factoring** – A company converts its A/R into cash by assigning or selling it either with or without recourse to a factor
    - **Sale without recourse** – The client sells the receivable to another party (a factor), with the buyer assuming the risk that the receivable may not be collectible.
    - **Sale with recourse** – The client sells the receivable to another party, with the buyer retaining the right to demand the client make good on the receivable if the customer does not pay as promised.

Transfers & Servicing of Financial Assets

Entities in general, and financial institutions in particular, transfer financial assets to other entities. The transfer may involve a single entire financial asset, such as a mortgage loan receivable; a group of financial assets, such as an entity's A/R; or a participating interest in a financial asset, such as a percentage of the entire financial instrument. (ASC 860)

- When a component of a financial asset that is not considered a participating interest is transferred, it will be accounted for as a secured borrowing with pledge of collateral.
- A component of a financial instrument is **a participating interest** if it has certain characteristics:
    - It represents a proportionate interest in the entire instrument.
    - All cash flows from the instrument, other than those allocated as compensation for services, are divided proportionately among participating interest holders.
    - The rights of all participating interests have the same priority and are not subordinated to one another.
    - All participating interests must agree in order for a party to pledge or exchange the entire financial instrument.

The accounting for a transfer of a financial instrument, group of financial instruments, or a participating interest in a financial interest is determined on the basis of whether or not the transferor has surrendered control of the instrument.

- If control has been surrendered, the transfer will be recognized as a sale, along with a related gain or loss.
- If control has NOT been surrendered, the transfer will be recognized as a secured borrowing with the financial instrument pledged as collateral.

Control of a financial instrument has been surrendered (considered a **sale**) only when all of the following three conditions are met:

1. The transferred financial instruments have been *isolated* from the transferor and *beyond the reach of the transferor* or its creditors, including creditors in bankruptcy.
2. Transferees have the *right to pledge or exchange* the asset it received without restrictions and without providing more than a trivial benefit to the transferor.
3. The transferor does *not maintain effective control* over the financial instrument, considering all of the transferor's continuing involvements with the instrument. The transferor does maintain effective control when:
    a. An agreement, entered into contemporaneously with the transfer, both entitles and obligates the transferor to repurchase or redeem the transferred financial assets at a fixed or determinable price.
    b. An agreement allowing the transferor the unilateral ability to require the transferee to return specific financial assets.
    c. An agreement allowing the transferee to require the transferor to repurchase the transferred financial assets at a price significantly favorable to the transferee.

Unless all three of these conditions are satisfied, the financial asset is considered to have been merely **pledged or assigned** as collateral for a loan (**borrowing** transaction).

In the cases of **pledging or assigning,** the company remains the legal owner of the financial asset, and simply records a liability for the amount borrowed:

Cash	X	
Note payable		X

Notes to the F/S will indicate the dollar amount of the financial assets that have been pledged or assigned. Alternatively, the company can identify these amounts on the face of the balance sheet:

A/R Assigned	X	
A/R		X

The remaining entries include normal entries to record interest and principal payments on the note, and collection of the receivables.

If control is surrendered and the transfer is **accounted for as a sale,** two other issues should be considered.

- A **factor's holdback** (also referred to as *"Due from factor"*) is an amount which provides a margin of protection against sales discounts, sales returns and allowances, and disputed accounts.
- A **recourse obligation** (*probable uncollectible accounts*) is an amount included as *protection for the transferee* against uncollectible accounts; such obligations result in a continuing interest in the asset.

To illustrate, assume an entity with A/R that are expected to have a net realizable value of $35,000 transfers them to another entity for $30,000.

If control is not surrendered, the transaction will be recognized as a secured borrowing:

Cash	30,000	
Interest expense	5,000	
Note payable		35,000

If control is surrendered, and the transferee withholds $5,000 from the proceeds for protection against future reductions resulting from returns, allowances, or disputed amounts, the transaction will be reported as a sale:

Cash	25,000	
Due from factor (withheld amount)	5,000	
Loss on sale of receivables	5,000	
A/R		35,000

- **Factoring** - The sale of short-term A/R. A factoring fee is applied by the buyer and is a straight percentage of the factored receivables.
- **Discounting** - The sale of long-term notes receivable. A discount rate is applied by the buyer and is an annualized rate that will vary depending on the length of time until collection is due.

In the case of sales, the buyer of the receivable becomes the legal owner of it, and the client reduces the carrying value of the receivables to zero, reporting a gain or loss for the difference between the proceeds from sale and the carrying value of the receivable. There is, however, a major difference between the treatment of sales without recourse (as most, though not all, factoring involves) and sales with recourse (as most, though not all, discounting involves).

In the case of a **sale without recourse**, the seller is relieved of any obligation on the receivable. Thus, if the buyer of the receivable is unable to collect from the customer, they cannot require the seller of the receivable to compensate them.

- The transferee (buyer) bears the risk of uncollectible accounts.
- The transferee does not, however, bear the risk of goods being returned, allowances made for nonconforming goods, or disputed balances.

Assume the client has gross A/R of $100,000, and an allowance for credit losses of $8,000. On that date, the client **factors all of the receivables without recourse**, and the buyer charges a factoring fee of 9% of the face amount ($100,000 × 9% = $9,000).

The entry is as follows:

Cash and Amount due from Factor (holdback)	91,000	
Loss on factoring	1,000	
Allowance for credit losses	8,000	
A/R		100,000

Notice that the client removes the entire allowance for credit losses, since the risk of collectability has been transferred to the buyer of the receivables (w/o recourse).

When receivables are **factored with recourse**, the client is liable for uncollectible accounts, and must report an estimated liability for the additional amounts that are expected to be paid to the buyer.

If $100,000 A/R with an allowance for credit losses of $8,000 has been **factored with recourse**, and the buyer is charging a 3% factoring fee on the face value ($100,000 × 3% = $3,000), the entry is:

Cash and Amount due from Factor (holdback)	97,000	
Loss on factoring	3,000	
Allowance for credit losses	8,000	
Liability on Transferred receivable		100,000
Estimated recourse liability		8,000

If the buyer is subsequently able to collect only $91,000, and the client is required to pay $9,000 on the uncollectible accounts, an additional loss is recorded as follows:

Estimated recourse liability	8,000	
Loss on factoring	1,000	
Cash		9,000

If the company sells the A/R to a factor in a transaction considered a *borrowing transaction*, this would be considered factoring with recourse.

Cash	X	
Factor's holdback	X	
Interest expense (discount)	X	
Liability on transferred		X

When an interest-bearing note receivable is sold to a bank, the usual process is known as **discounting**. The bank first determines the maturity value of the note, meaning the total payment of principal and accrued interest that is due at maturity. This amount is then reduced by a discount rate, and the bank pays the net result. Notes receivable that have been discounted *with recourse* are reported on the balance sheet with a corresponding contra account (notes receivable discounted). Notes receivable discounted *without recourse* have essentially been sold and should be removed from the balance sheet.

For example, assume the client sells inventory on 6/30/X1 for $100,000, and receives a one-year note for $100,000 bearing interest at 10% (the market rate of interest). The entry for the sale (we'll ignore cost of sales for this illustration) is:

6/30/X1		
Note receivable	100,000	
Sales		100,000

That same day, the client discounts the note at a bank at a 10% discount rate. The amount to be received is calculated as follows:

Face value	100,000
Interest at maturity (10%)	10,000
Maturity value	110,000
Discount (10%)	11,000
Net paid by bank	99,000

Notice the client is not collecting the face value, even though the bank rate is the same as the effective rate on the note, because bank interest is computed on the maturity value. The entry for the discounting activity is:

6/30/X1		
Cash	99,000	
Loss on discounting	1,000	
Note receivable		100,000

If the note has been **discounted with recourse**, the client should disclose a contingent liability for the amount that might have to be paid if the customer defaults to the bank.

Both the interest rate on a note and the discount rate charged by a bank are annual rates, so the calculations are affected by the holding period.

Face amount
+ Interest (Interest = Face × Interest Rate × Term)

Maturity value
− Discount (Discount = Maturity value × Discount Rate × Time Remaining)

Proceeds

Accounting for Transfers of Participating Interests

An entity may have only a **participating interest** in a financial instrument. To be considered a participating interest, certain characteristics must apply:

- The interest represents a proportionate interest in the entire instrument.
- All cash flows from the instrument are divided proportionately among all participating interests.
- Each participating interest is given the same priority.
- No entity has the ability to pledge or exchange the entire instrument without the consent of all participating interest holders.

When a transfer of a participating interest qualifies as a sale, the transaction is accounted for as follows:

1. Consideration received is recognized at its fair value.
2. The carrying value of the entire instrument is allocated between the participating interest transferred and the interests retained on the basis of their relative fair values.
   a. The portion allocated to the participating interest sold is eliminated.
   b. The difference between that and the fair value of consideration received is recognized as a gain or loss in earnings
3. The remaining carrying value becomes the carrying value of the retained interests.

For example, assume a company has a note receivable with a face and carrying value of \$580,000. The entity decides to transfer 40% of the note for \$260,000 to another entity at a time when the fair value of the receivable is \$650,000. As a result, the fair value of the 40% participating interest being transferred is \$260,000 and the fair value of the retained interests is \$390,000. The carrying value will be allocated as follows:

- Participating interest transferred - \$260,000/\$650,000 × \$580,000 = \$232,000
- Retained interests - \$390,000/\$650,000 × \$580,000 = \$348,000

There would be a gain on sale:

Sales price	\$260,000
Basis	\$232,000
Gain	\$ 28,000

The resulting entry would be:

Cash	260,000	
Gain on sale		28,000
Note receivable		232,000

Servicing of Financial Assets

Financial assets, notes receivable in particular, require what is referred to as **servicing**. Servicing of a note receivable includes such administrative functions as sending debtors monthly statements, collecting payments, allocating payments between principal and interest, and sending tax information forms to the debtor. It is fairly common for the seller of a financial asset or a participating interest in a financial asset to retain the obligation to service the receivable, referred to as servicing rights.

- The entity with the servicing rights may not receive any compensation or may receive compensation that is below the fair compensation for performing the servicing obligations, in which case the entity has a *servicing liability*.
- The entity may receive compensation that exceeds the fair compensation for performing the servicing obligations, in which case the entity has a *servicing asset*.

In addition to recognizing a service asset or liability when servicing rights are retained upon the sale of a financial instrument or a participating interest in one, an entity will also recognize a servicing asset or liability when it acquires or assumes a servicing obligation for a financial instrument in which it has no direct interest.

A **servicing asset or servicing liability** is initially recognized at its **fair value**, regardless of whether or not consideration was received. Once recognized, servicing assets or liabilities may be accounted for under either of two methods:

- **Amortization method**
  - The asset, when revenues will exceed costs, or liability, when costs will exceed revenues, is amortized over the period during which servicing income (asset) or loss (liability) will be recognized.
  - The amortization will be in proportion to the amount of income or loss.
  - The asset or liability is assessed for impairment (asset) or increased obligation (liability) at each reporting date.
- **Fair value method**
  - The servicing asset or liability is adjusted to fair value on each reporting date.
  - Increases or decreases are reported in earnings.
  - Selecting the fair value method involves an irrevocable election.

In addition to servicing assets and liabilities, there are other ways in which financial instruments are divided with some of the various components being transferred and others retained. One component is referred to as an **interest-only strip (I-o strip).** Sometimes they are retained as part of the consideration for the portion of the instrument transferred. In other cases, they are considered compensation for the service obligations.

- I-o strips are considered financial instruments, not servicing assets.
- The entity receives a proportionate amount of each interest payment received.
- They are reported at fair value when received.
- They are subsequently accounted for as available for sale securities or trading securities, as appropriate.

Securitization

Financial assets may be securitized in order to make them easier to transfer. Securitization is the process of converting financial assets into securities. It is accomplished when a group of homogeneous securities are combined into a pool and transferred into an entity referred to as a securitization mechanism. A group of mortgage notes receivable, for example, may be transferred to a real estate investment trust (REIT). Shares in the trust can then be sold to investors as securities.

Payments received by the securitization mechanism may be classified as either:

- Payments used to pay off debt securities, referred to as *pay-through*; or
- Payments attributed to investors, referred to as *pass-through*.

In certain circumstances, referred to as *revolving period securitizations*, receivables are transferred at the inception and also periodically thereafter. During the term, referred to as the revolving period, cash collections are used to purchase additional receivables from the transferor.

Assume an entity sells a loan for $44,000, retaining servicing rights and a 1% interest only strip. The loan has a book value of $45,000 and, on the date of transfer, the fees that will be received for the servicing is expected to exceed the cost of performing the servicing, resulting in a servicing asset with a fair value of $4,100. The I-o strip has an estimated fair value of $2,200 at the date of transfer.

Proceeds consist of:

Cash	$44,000
Servicing rights (at fair value)	4,100
I-o strip (at fair value)	2,200
Total	$50,300

Since the carrying value of the receivable was $45,000, there would be a gain on sale of $5,300. The journal entry would appear as follows:

Cash	44,000	
Servicing rights	4,100	
I-o strip	2,200	
Note receivable		45,000
Gain on Sale		5,300

Accounting for Collateral

When a debtor provides a creditor with collateral for a loan, the accounting for it will depend on who retains control of the collateral. In most circumstances, the transferor (debtor) retains control of the collateral.

- It remains as an asset on the debtor's F/S.

- The fact that it is collateral for a debt is disclosed.
- The transferee (creditor) does not recognize the asset in its F/S.

Upon default, the creditor will take control of the collateral.

- The debtor will eliminate the carrying value of the asset, the carrying value of the debt and related accounts, such as accrued interest, and recognize a gain or loss for the difference.
- The creditor will recognize the asset at fair value, derecognize the receivable, and recognize a gain or loss (generally a loss), as appropriate.

When the transferee has control of the collateral, it recognizes an asset and a corresponding liability, recognizing the obligation to return the collateral upon settlement of the debt instrument. Since the transferor will no longer have possession of the collateral, it will be reported as a receivable. If the debtor defaults:

- The debtor will eliminate the liability and the receivable with the difference representing a gain or loss.
- The creditor will eliminate the receivable and the liability to return the collateral, with the difference representing a gain or loss.